CLIFFORD

CHANCE

Briefing note

February 2016

1. The end of contracting-out from 6 April

The abolition of contracting-out is fast approaching and is raising a number of issues along the way. In particular, trustees and employers should be aware of the following:

Disclosure requirements

Whilst the 60 day consultation requirement applies only when making changes to benefits and/or member contribution rates, some form of communication is still expected absent any such changes.

In terms of what is strictly required under the legislation, this is not particularly clear. When the Government published its consultation response on *the Occupational Pension Schemes (Schemes that were Contracted-Out) (No.2) Regulations 2015* last year, it said that some respondents had asked whether there would be a requirement for employers to notify and consult with members and the DWP would address this issue in a further consultation on changes to the *Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013* (the "**2013 Disclosure Regs**").

The Government has since consulted on the draft Pensions Act 2014 (*abolition of contracting-out for salary related pension schemes*) (*consequential amendments*) order 2016 (which closed in November and is awaiting response). As part of this consultation, the DWP has made clear that it expects trustees to be notifying active members in contracted-out employment about the change as it amounts to a material alteration to the "basic scheme information" which trustees are required to notify of under the 2013 Disclosure Regs. (Notification should be made as soon as possible after (and, in any event, within three months of) the change).

Currently, the Employment Rights Act 1996 (the "**ERA**") requires employers to provide employees with a written statement setting out their employment particulars when they start work. Under section 3(5) of the ERA, this statement must include a note on whether there is a contracting-out certificate in force regarding such employment. Any change to this information must be notified to employees (at the earliest opportunity (and, in any event, within one month of the change). However, section 3(5) is being repealed from 6 April 2016. In our view, this means that, technically, the duty to inform members of the change under the ERA does not kick in.

In practice, we expect most trustees and employers will already be planning (if they have not done so already) to notify active members (perhaps via a joint communication) about the end of contracting-out and the fact that individuals will face increased National Insurance

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contributions (and a reduction in their take-home pay) as a result. This is advisable in the interests of avoiding member queries later on.

GMP revaluation

What is the issue all about?

Currently, the early leaver rules are triggered when a member leaves contracted-out service – not when they leave *pensionable service* of a scheme as a whole. As a result, Guaranteed Minimum Pensions ("**GMPs**") must be revalued from April 1997 (when they ceased to accrue) until the date a member leaves contracted-out service in line with the "section 148" method.[1] On leaving contracted-out service, a scheme can (if its rules permit) then choose whether to continue with s148 revaluation or switch to "fixed rate" revaluation. [2]

The Government has made clear that it does not intend for the abolition of contracting-out at law to trigger the early leaver rules on 6 April 2016 for those who remain in pensionable service. Instead:

- For those who ceased contracted-out service **some time before 6 April 2016**, the position remains unchanged (i.e. section 148 revaluation applies until the member left *contracted-out service*; at which point the scheme chose whether to switch to fixed-rate or continue with section 148 revaluation).
- For those who cease contracted-out service **on 6 April 2016** but otherwise remain in pensionable service, section 148 revaluation must continue until the member leaves *pensionable service*; at which point the scheme can choose whether to make the switch. There are also bullet points.

Why does an issue arise?

Although consistent with this policy intent, the new legislation is not overriding and the way scheme rules interact with the legislation could cause issues for schemes that wish to use fixed rate revaluation.

This is because the legislation only provides for the possibility of a switch to fixed rate revaluation on leaving *pensionable service*, but scheme rules typically refer to the switch applying on leaving *contracted-out service*. This results in a conflict and raises concerns that a scheme which switches to fixed rate revaluation on leaving *contracted-out service*, may have to apply a section 148 underpin (and essentially give the better of the two revaluation rates) when contracting-out ceases on 6 April until the member leaves *pensionable service*.

What action should be taken?

There are a few options. If possible, the preferred route in the interests of clarity is likely to be to amend scheme rules before 6 April. However, this may not be necessary (or possible e.g. if the scheme rules contain a restrictive amendment power) and in some cases, scheme rules may be capable of being interpreted in line with the new legislation (and simply documenting the trustee and employer's agreed approach to revaluation).

The industry has raised this with the DWP and it is hoped that there may be a resolution introduced although possibly not before 6 April.

GMP increases

Currently, pensioners over state pension age receive increases on the whole of their GMP. These increases are funded partly by schemes and partly by the Government –schemes are only required to pay increases on the part of the GMP earned from 6 April 1988 to 5 April 1997 (up to a maximum of 3% each year) and all other increases on the GMP are met by the Government as part of an individual's state pension entitlement.

However, as part of the state pension reforms, for anyone who reaches state pension age after 5 April 2016, the Government has confirmed that it will no longer be providing these increases.

Schemes should be aware of the issue as affected members may have questions. Schemes may also wish to review past member communications to see what members were told about GMP increases and consider whether to inform them of the changes.

2. Reminder of tax-relief changes coming into force this April

With effect from 6 April, changes will be made to the amount of tax-relieved saving an individual can make in UK registered pension schemes. In particular:

- The Annual Allowance ("**AA**") (currently £40,000), is being reduced for certain high earners. This means that for anyone with "adjusted income"[3] over £150,000, the AA will reduce by £1 for every £2 over £150,000, ultimately reaching £10,000 for anyone with adjusted income of £210,000 or more. Although if an individual's "threshold income"[4] is £110,000 or less, they will not be affected. It's likely that individuals will want to make use of any unused AA they have between now and 6 April (including any unused carry forward from the previous three tax years).

HMRC has recently published a consultation on legislation which would change the information requirements for scheme administrators (generally, trustees) in relation to the new AA. The consultation remains open until 17 February and the legislation is still in draft at this stage, but the intention is for schemes to provide pension savings statements to members where their "pensionable earnings"[5] for a tax year exceed £110,000 to help members work out whether or not they are subject to the reduced AA.

- The Lifetime Allowance ("**LTA**") is also being reduced to £1m (currently £1.25m). It will then be increased annually in line with inflation (as measured by the Consumer Prices Index) from 6 April 2018.

  At the same time, two new forms of protection are being introduced for those at risk of reaching the LTA: "Fixed Protection 2016" and "Individual Protection 2016". Those wishing to claim Fixed Protection 2016 must cease all future pension saving in UK registered schemes before 6 April 2016.

  HMRC has provided details about the application process for these forms of protection in its recent newsletters. Specifically, HMRC has confirmed that the new online application process will not be available until July 2016, with an interim process being introduced for those wishing to apply between 6 April and July (no applications can be made before 6 April). The interim process involves making a temporary application by writing to HMRC with details of an intention to rely on Fixed Protection 2016 or Individual Protection 2016. It will be important to ensure that any temporary applications are subsequently converted into full applications once the online system goes live in July.

Separately, it remains to be seen whether there will be further radical changes to the pensions tax relief system; with increasing speculation that the system will not be left as it is. We will have to wait until 16 March (Budget day) for the Chancellor's response on this.

3. Revised Code on Incentive Exercises

A revised version of the Code of Good Practice on Incentive Exercises was recently published. The original Code was introduced in 2012 in response to industry and Government concerns about the way in which "**Incentive Exercises**"[6] were being exercised. The Incentive Exercises Monitoring Board (the "Incentives Board") undertook a review of the 2012 Code last year and the Code published this month is an updated version of this.

The Code is voluntary (this has not changed). However, compliance may assist if faced with member complaints, as both the Pensions Ombudsman and Pensions Regulator have regard to the Code, where relevant.

Key points to note about the new Code include:

- **Proportionality threshold** – this threshold is new and softens some of the Code's requirements in certain circumstances. Broadly, it provides that where an exercise involves a small pension (transfer exercises where the transfer value is £10,000 or less; a cash commutation of £10,000 or less; or in a pension increase exchange where pensions being modified are worth £500 a year or less), the requirement to provide "advice" is softened and instead, "IE guidance" should be made available.

  IE Guidance involves paying for an independent financial adviser to assist the member in making a decision; but there is no formal written contract with the member; no individual tailoring of guidance to member circumstances following a fact-find; generally no face to face or telephone meetings (unless the member is a "vulnerable client") and no recommendation is made to the member, unlike with "advice".

- **Full Commutation** – the new Code now expressly covers exercises where members are offered a cash lump sum in full replacement for a pension. This reflects an announcement made by the Incentives Board in December 2014 that one-off trivial and small pension commutation exercises would generally be expected to fall within scope.

- **The "spirit" of the Code** – there is a clear focus on following the "spirit" of the new Code and the Incentives Board says it does not expect people to look for creative ways to work around the Code.

- **Boundary examples** – a set of "boundary examples" has been published alongside the new

Code; designed to help illustrate how it should be applied in practice. These focus on the distinction (or "boundary") between incentive exercises and "business as usual" activity (to which the Code does not apply). A key theme coming out of these examples is that "one-off" and time-limited exercises are likely to be considered incentive exercises. In contrast, exercises which are open-ended and available on an ongoing basis on the same terms for all members (and where this is made clear in member communications) are more likely to fall into the "business as usual" bucket. Although even in these "business as usual" circumstances, parties are encouraged to adopt the Code's principles.

- **Implications for winding-up lump sum exercises (or "WULS")** – the 2012 Code did not apply to WULS exercises. Whilst the new Code says that in "many cases" WULS can be expected to fall outside the scope of the Code, this area is under review. The Incentives Board will consult the industry during 2016 on whether or not it should be specific about which types of WULS should fall within the revised Code. It is therefore likely that there will be some progress on this in the future and certain types of WULS exercise may well fall within the Code's scope.

4. Government consults on reforms to public sector exit payments

The Government has recently launched a new consultation which considers options for further reforming public sector exit payments, with a view to making payment terms "fairer, more modern and more consistent".

Amongst the options being considered are:

(i) tapering the amount of lump sum compensation an individual can receive as they get closer to normal pension age (or a target retirement age); and

(ii) requiring employer-funded early access to pensions (referred to as "employer-funded pension top-ups") to be limited or ended through one or more of a range of measures that would reduce costs. These measures include (i) limiting the amount which can be paid (note that the value of these payments has already been proposed for inclusion within the £95,000 cap on the value of an exit payment that can be funded by an employer under the draft *Public Sector Exit Payment Regulations 2016*, published at the end of last year – so this would be a further restriction); (ii) removing access to them altogether; and/or (iii) increasing the minimum age at which an employee is able to receive a top-up.

Payments made by employers in relation to injury, ill-health or death during employment are outside the scope of the proposals. The consultation closes on 3 May 2016.

5. ESMA publishes opinions on exemptions for pension schemes from derivatives clearing obligations

The European Market Infrastructure Regulation (648/2012) ("**EMIR**") came into force in August 2012 and requires over the counter ("**OTC**") derivatives to be cleared.

However, "pension scheme arrangements" (as defined under EMIR) benefit from a transitional exemption which means they do not have to comply with this clearing obligation when they enter into OTC derivatives contracts. The transitional exemption was originally due to expire on 16 August 2015, but this was subsequently extended until August 2017.

The way the exemption works means that certain pension scheme arrangements (including, institutions for occupational retirement provision i.e. a UK registered occupational pension scheme) automatically benefit from the exemption, whereas others (namely, the occupational retirement provision businesses of life insurance undertakings and certain other authorised/supervised arrangements operating on a national basis) need to obtain prior authorisation before they can benefit from the exemption. In the UK, this requires a request to be made to the Financial Conduct Authority ("**FCA**"). The FCA must obtain the opinion of the European Securities and Markets Authority ("**ESMA**") before making a decision.

ESMA recently published a document setting out the opinions it provided to the FCA on the application of the transitional exemption (in each case, confirming a view that the availability of the exemption is justified). These relate to 16 different types of UK-based pension arrangement, including, broadly:

- a "buyout pension scheme" which is the business of a life insurance undertaking (where all assets and liabilities are ringfenced from the other activities of the insurance undertaking);
- certain authorised pooled funds established for pooling assets relating to the provision of retirement benefits;
- an employer or industry-wide arrangement which is not considered an institution for occupational retirement provision and meets certain other requirements; and
- an arrangement providing individual pension scheme arrangements, which is established and authorised in the UK and meets certain other requirements.

ESMA has said that, after the FCA grants the exemptions (although note that the FCA is not bound to follow the opinion of ESMA), ESMA will publish a list of the types of entities and arrangements that have been exempted. This will be helpful for certain types of pension arrangement looking to rely on the transitional exemption in future.

6. Auto-enrolment developments

The last couple of months have seen a few developments on the auto-enrolment front.

New earnings bands published

A draft order setting out the new earnings bands has been laid before Parliament. The provides that for the 2016/17 tax year:

- The upper end of the qualifying earnings band will increase to £43,000 pa (from the current £42,385 pa);
- The lower end of the qualifying earnings band will remain fixed at £5,824 pa; and
- The earnings trigger will remain fixed at £10,000 pa.

As employers will be aware, these bands are relevant for determining which category a worker falls into for auto-enrolment purposes. Broadly;

- "**Eligible jobholders**" are workers between age 22 and stage pension age, who ordinarily work in the UK and earn in excess of the earnings trigger (i.e. £10,000 pa). (These people must be automatically enrolled into an automatic enrolment scheme, unless already an active member of a qualifying scheme and minimum employer contributions must be paid based on earnings within the qualifying earnings band (i.e. under the new bands, earnings between £5,824 pa and £43,000 pa)).
- "**Non-eligible jobholders**" are workers either:
  - aged between 16 and 74, who ordinarily work in the UK and who earn less than the earnings trigger (i.e. £10,000 pa), but more than the lower end of the qualifying earnings band (i.e. £5,824 pa); or
  - aged between 16 and 21 or stage pension age and 74, who ordinarily work in the UK and who earn above the earnings trigger (i.e. £10,000 pa).

  (These people have the right to opt into the employer's automatic-enrolment scheme, in which case the employer must pay contributions).
- "**Entitled workers**" are workers between ages 16 and 74, who ordinarily work in the UK and earn less than the lower end of the qualifying earnings band (i.e. £5,824 pa). (These people have the right to join a pension scheme sponsored by their employer, but this does not have to be an automatic enrolment scheme and the employer is not required to make contributions).

The draft order is due to come into force on 6 April 2016.

Clarity on who is "ordinarily working" in the UK

The High Court has provided the first judicial guidance on what it means to be "ordinarily working" in Great Britain ("**GB**")[7] for the purposes of auto-enrolment.

Fleet Maritime Services (Bermuda) Ltd) v the Pensions Regulator[8] is a judicial review case dealing with whether travelling workers were considered "working or ordinarily working" in the UK (and therefore, jobholders for the purposes of auto-enrolment legislation).

This case involved an employer of seafarers who worked on cruise ships. All the cruise ships spent a significant majority of their time outside UK waters. The employer argued that most of its staff where not covered by the auto-enrolment legislation as they were international workers. The Pensions Regulator issued a compliance notice and the employer requested a review of this. The Regulator affirmed its decision; resulting in a judicial review application by the employer.

The Judge confirmed that for these travelling workers, the correct test to apply is the "base" test, rather than the contract test. This means that it is necessary to look at what actually happens in practice (i.e. what actually happens under the contract), rather than the terms of the original employment contract (i.e. what the contract envisaged when entered into). This is particularly so where the test has to be applied continually over time, as it does when considering whether a worker is a jobholder for auto-enrolment.

Applying this to travelling workers, the Judge concluded that:

- A seafarer may be regarded as ordinarily working in GB during any period when the seafarer is working from a base situated in GB even if the ship on which the seafarer works spends most of its time outside GB.
- A seafarer who lives in GB and whose tours of duty habitually begin and end at a port in GB may be regarded as based in GB and hence as a worker who ordinarily works in GB.
- A seafarer who lives in GB but who works on a ship which spends all or most of its time outside GB and whose tours of duty do not habitually begin and end in GB cannot be regarded as based in GB or as a worker who ordinarily works in GB.

7. Scots courts reject appeal challenging validity of scheme rule amendments

The Inner House in Scotland (akin to the Court of Appeal in England and Wales) has handed down judgment in the case of *Scottish Solicitors Staff Pension Fund v Pattison & Sim and others*.[9]

This concerned an appeal by the partners of a law firm, who argued that they were not liable to pay arrears of pension contributions as rule amendments made as far back as 1980 were invalid. The trustees had been unable to produce evidence showing full compliance with the amendment power (which required amendments to be approved at three separate meetings).

The Inner House rejected the appeal and affirmed the decision given at first instance – that the scheme amendments and procedures carried out were valid. Of particular note, the court said:

- If an amendment power imposes conditions for its valid exercise, these must be satisfied, but in considering this, the primary aim is for the exercise of the power to be clear and certain and put into some sort of permanent form – a court should not be "unduly technical or restrictive" in considering the niceties of the manner in which it was exercised.
- In considering transactions that have taken place a significant time ago, there is a general presumption that all the necessary procedures have been properly followed (applying the maxim that "all things are presumed to have been done duly and in the usual manner"). The burden of proving otherwise rests on the challenging party.
- This general presumption was strengthened by the declaration in the recitals to the amending deeds (which narrated that the amendments were carried out in accordance with the appropriate procedure). The onus was therefore on the partners to establish that proper procedures were not followed and in the court's opinion, they were unable to do this.

This case demonstrates that the Scots courts take a more pragmatic approach to interpretation than the English courts. Although not of legal force in England and Wales, it will be interesting to see whether this decision is considered in the appeal against the High Court decision in *Briggs and others v Gleeds and others*,[10] which we understand is due to be heard in July.

8. High Court approves rectification application without trial

The case of Hogg Robinson plc v Harvey and others[11] concerned an application by the scheme employer for summary judgment on its claim for rectification of a deed of amendment. The employer and trustees had resolved to amend the scheme rules to reduce the rate of increases applied to both benefits in payment and benefits in deferment, but the deed only amended benefits in payment. The deed purported to take effect from 1 August 1999, but was not executed until 8 September 1999.

The Judge allowed the application and issued a declaration order (providing that the changes in benefits cannot apply to pensionable service before 8 September 1999 when the deed was executed; as this is prohibited by law (i.e. section 67 of the Pensions Act 1995)). The Judge took the view that:

- In line with previous case law, there needs to be "cogent evidence" of the intentions of the trustees and the employer where the amendment power requires the consent of both.

- The collective intentions of the parties need to be established objectively, at the time the amending deed was executed by each.
- Applying these principles, there was no doubt that the employer and trustees had intended to amend the rules to reduce the rate of increases applied to both benefits in payment and in deferment.
- Every potential defence to rectification has been investigated as a realistic basis on which to defend the claim.
- It was in all parties' interests that there should not have to be a full trial.

This is not the first case where the court has been willing to grant rectification without trial and helps to demonstrate that a rectification claim does not have to involve lengthy court proceedings (and as a result, significant costs) where there is clear evidence to demonstrate the parties' intentions and the parties have first considered any potential defences to the claim and investigated these thoroughly. It may have also been helpful in this case that members were informed about the application (and given the chance to object), as well as having been informed of the correct intention at the time the amending deed was signed, such that no one had actually been misled.

9. Update on US data protection issues

The decision of the European Courts in October of last year to rule the US "safe harbor" regime invalid with immediate effect, means that this can no longer be relied on for transfers of personal data from the EU to the US.

EU data protection laws prohibit transfers of personal data to countries outside the EEA which do not ensure "adequate protection" for the data. The "safe harbor" regime had been a key tool used by businesses to ensure adequate protection. (Please see our last edition of UK: Pensions Update for more details).

Following the decision in October, representatives of the European Commission and the US Department of Commerce have been trying to reach a new agreement which would adequately address concerns in relation to the protection of data transferred from the EU to the US.

The proposed new arrangement would impose enhanced obligations on US companies to protect EU personal data and give new monitoring and enforcement powers to the US Department of Commerce and Federal Trade Commission, as well as the establishment of a new Ombudsman to deal with individual queries. The new arrangement is still under review and a decision as to its adequacy is to be delivered by the European Commission in the next few weeks.

For further details, please see the Firm's briefing paper accessible at the following link: http://www.cliffordchance.com/briefings/2016/02/a_new_safe_harbortheeu-usprivacyshield.html.

10. New legislation means increased flexibility for tax-efficient investment in US real estate by non-US pension schemes

The Protecting Americans from Tax Hikes Act 2015 has made significant changes to rules governing investment in real estate. Significantly, the new legislation exempts "qualified foreign pension funds" from pre-existing investment restrictions which means that they will not be subject to US tax under the Foreign Investment in Real Property Act 1980 in respect of distributions from US real estate investment trusts ("**REITs**").

Before the new legislation was introduced, if a qualified foreign pension fund owned more than 5% of a publicly traded class of stock of a REIT or held shares in a private REIT, under the 1980 Act, it would be subject to US tax on any distributions from the REIT deemed to be attributable to a gain on the sale of a US real property interest.

The new legislation increases the 5% limit to 10% generally for all foreign investors, but exempts qualified foreign pension funds completely, such that a qualified foreign pension fund could exceed this 10% limit, without being subject to US tax on distributions from the REIT.

These changes make investment in US real property investment significantly more attractive as a result.

1. Broadly, this involves revaluing the GMP in line with increases in average earnings.
2. Broadly, this involves revaluing the GMP in line with fixed percentage rates prescribed by legislation.
3. "adjusted income" is defined to include an individual's total taxable income, plus any pension contributions made by the member from any employment income and the value of the increase in their pension rights in that pension arrangement for that tax year funded by their employer (for defined contribution schemes, this means employer contributions and for defined benefit schemes, this is the increase in the value of the individual's pension rights in that arrangement for that tax year, but less their own contributions (to avoid double counting)).
4. "threshold income" includes all taxable income. However, unlike adjusted income it generally excludes pension contributions and the value of the increase in pension rights funded by the employer. Although it will include any contributions paid by way of any new salary sacrifice arrangements made on or after 9 July 2015. (What is considered a "new" arrangement for these purposes is quite wide).
5. The draft definition covers the member's salary, wages or fee in respect of the employment to which the scheme relates.
6. An "Incentive Exercise" is defined under the Code as:

   "*an invitation or inducement… provided to a member to change the form of their accrued defined benefit rights in a UK registered pension scheme, which meets both of the following tests:*

   - *one objective of providing the invitation or inducement is to reduce risk or cost for the pension scheme or sponsor(s); and*
   - *the invitation or inducement is not ordinarily available to members of the pension scheme.*"
7. Corresponding Northern Irish legislation means the reference to Great Britain can be treated as a reference to the UK.
8. [2015] EWHC 3744.
9. [2015] CSIH 96.
10. [2014] EWHC 1178 (Ch).
11. [2016] EWHC 129 (CH).

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